

# **MONTANA STATE FUND 2012 BUDGET ANALYSIS OLD FUND AND NEW FUND**

A Report Prepared for the  
**Legislative Finance Committee**

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## **EXECUTIVE SUMMARY**

The Montana State Fund (MSF) provides employers with an option for worker's compensation insurance and occupational disease insurance and guarantees available coverage for all employers in Montana. The management and control of MSF is vested solely in the Board of Directors (board)

The following provides an executive summary of the budget analysis of MSF. Further detail is provided in the accompanying report.

### **Impacts of HB 334**

The National Council on Compensation Insurance (NCCI) advisory loss costs developed based on the changes included in HB 334 reduce loss costs in Montana by 22.4%. Loss costs are the first component of workers' compensation premiums. In addition, NCCI filed an additional advisory for FY 2012 for loss costs level changes, an additional reduction averaging 5.6%. Taken together NCCI estimates the average decrease in loss costs in FY 2012 will be 26.7%.

### **Rates**

Overall MSF manual premium rates will decrease an average of 20.0% from those established for FY 2011. The board adopted the NCCI estimates on the costs of providing indemnity and medical benefits to workers injured in FY 2012 as the beginning of the rate determinations. The board then adopted a multiplier to provide for the changes to NCCI loss costs, costs of the operating MSF, investment income results, and additions to equity.

### **Achievement of Reserve to Equity Targets**

Overall, the long term risk associated with the funds of MSF is that the net earned premiums collected in a year could be insufficient to pay all benefits, claims, and operational costs associated with worker's injuries over the long period the benefits and claims are paid out. To monitor this risk in the New Fund, the budget analysis has focused on reserve to equity ratio targets. The ratio has improved in recent years. The lower the ratio, the less the long term risk to the funds. The MSF projects it will achieve a reserve to equity target of 2.86 to 1.0 in FY 2011, an improvement from the target of 3.05 to 1.0 adopted by the board in the FY 2011 Strategic Business Plan. The reserve to equity target for FY 2012 as adopted by the board in the FY 2012 Strategic Business Plan is 2.70 to 1.00.

### **Increasing Statutory Operational Expense Ratio**

The FY 2012 budgeted operational expense ratio is 32.3%, a decrease from FY 2011. However, the operational expense ratio as a percentage of net premium revenues has increased since FY 2009, going from 20.3% to 32.8% in FY 2011. In FY 2011 the increase is driven by higher claims costs that resulted in less contingent commissions from the reinsurance program. The FY 2012 ratio results from static operating costs and decreasing net premiums.

### **General Fund Transfers to the Old Fund**

The state's general fund is responsible for the payment of claims and related administrative costs of the funds at the time they are due once the current resources of the funds are exhausted. The cost to the general fund for the Old Fund is actuarially estimated to be \$21.5 million over the 2013 biennium.

## INTRODUCTION

The Montana State Fund (MSF) provides Montana employers with an option for worker's compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. The management and control of MSF is vested solely in the Board of Directors (board).

Due to significant unfunded liabilities associated with workers' compensation in Montana, the May 1990 Montana Special Legislative Session separated funding and accounts for claims and injuries resulting from accidents occurring before July 1, 1990 (Old Fund) and claims occurring on or after July 1, 1990 (New Fund). Statute requires that MSF present the board approved budgets for the Old Fund and New Fund (the funds) to the Legislative Finance Committee (LFC) no later than October 1 for their review. While the LFC reviews the MSF 2012 budget, it has no authority to require MSF to change its budget unless it amends statute. The only entity charged with overseeing and approving budgets, operations, and expenditures of MSF is the Board of Directors.

This report discusses the analysis of the MSF board approved 2012 budgets for both the New and Old Funds, which are attached. It also discusses the FY 2011 budget and actual costs, and general fund transfers required in the 2013 biennium. In summary, the report outlines the following:

- Impacts of HB 334 on workers' compensation costs
- Decreasing loss costs
- Decreasing manual rates
- Achievement of reserve to equity targets
- Increasing operational expense ratio
- General fund transfers of \$21.5 million needed for Old Fund in the 2013 biennium

## IMPACTS OF HB 334 ON MSF WORKERS' COMPENSATION INSURANCE COSTS

The 2011 Legislature passed HB 334, an act revising workers' compensation laws in Montana, to address workers' compensation insurance costs and provide for stay at work/return to work options for injured workers.

The National Council on Compensation Insurance (NCCI) develops advisory loss costs for workers' compensation insurance in Montana that are the basis for the premium costs of workers compensation insurance. For FY 2012, NCCI filed two loss cost advisories.

First, NCCI filed a loss cost level change for FY 2012 which included a 5.6% loss cost reduction. The filing included changes for:

- Experience changes: (5.6%)
- Trend changes: (2.4%)
- Benefits: 2.9%
- Loss Adjustment Expenses: (0.4%)

The second filing addresses HB 334. The combined impact on the average workers' compensation loss costs between the two NCCI filings is a reduction in average loss costs of 26.7%. The second filing includes a number of changes that NCCI estimates, four of which will lower the anticipated costs of workers' compensation insurance in Montana and one that will increase anticipated costs:

- Revisions to permanent partial disability awards: ( 1.7%)
- Requirements for terminating and reopening medical benefits: (12.1%)
- Freezing medical fee schedules through June 30, 2013: ( 2.3%)
- Allowing insurers to designate the injured workers' health care provider: ( 8.5%)
- Establishing retroactive period for payment of indemnity benefits: 0.5%

Overall, NCCI estimates the sections of the statute that will have an immediate and quantifiable impact will result in a further average cost decrease of 22.4% beginning in FY 2012. NCCI included this average cost decrease in its filing of advisory loss costs in Montana for FY 2012. It should be noted that the impacts on specific job classifications are higher or lower than 22.4%.

Other sections of the statute may have additional savings but either the sections have no immediate or significant cost impact or the cost impact could not be explicitly determined by NCCI. These include:

- Defining course and scope
- Implementation of utilization and treatment guidelines
- Use of the 6<sup>th</sup> Edition of the AMA Guides to the Evaluation of Impairment
- Use of settlements and lump sum payments
- Stay at Work/Return to Work Programs designed to reduce the length of time the injured worker is off the job due to injury

## DECREASING LOSS COSTS

Premiums for workers' compensation insurance are comprised of several components:

- Loss costs – estimate of the costs of indemnity and medical benefits for workers injured during the year over the lifetime of the claim
- Loss adjustment expenses – the costs of administering the claims associated with injuries over the lifetime of the claim
- Operating costs – the costs of issuing a policy, including insurance agent commissions and costs for staff, advertising, training, etc.
- Rating and reinsurance programs – costs associated with providing reinsurance to offset high claim costs
- Profit and Contingencies – costs for unknown or unexpected expenses such as larger than expected loss costs, changes to benefits, and court decisions

The starting point for MSF premium rates is the adoption of NCCI loss costs. During its May 2011 meeting, the board approved using NCCI loss costs, including the average loss cost reduction of 26.7%, as a basis for MSF premium rates for Montana businesses. The 26.7 % decrease is an average for all Montana industries. Actual amounts vary by industry and job classification or class code.

Since FY 2006 MSF loss costs charged to businesses, on average, were lower than NCCI loss costs creating a gap between NCCI and MSF loss costs. The gap has been narrowing since FY 2006. The mechanism used to align NCCI loss costs and MSF loss costs is the loss cost multiplier. This is discussed further below.

## DECREASING MANUAL RATES

The loss cost multiplier includes adjustments to NCCI loss costs, a component for costs to operate MSF in FY 2012, reductions or increases in investment income, and the amount of funding needed for equity. Loss costs multiplied by the loss cost multiplier result in the manual rate for businesses insuring with MSF. In FY 2012 the board adopted an average manual rate decrease of 20.0%, the result of changes to the loss cost multipliers.

The changes to the loss cost multipliers (LCM) are based on:

- Narrowing differences between NCCI loss costs and MSF loss costs
- Decreased contribution to equity
- Static operational costs
- Less investment income on reserves over time

## Narrowing Differences between NCCI Loss Costs and MSF Loss Costs

As discussed above, since FY 2006, on average, MSF has adopted lower loss costs than NCCI. MSF uses rating tiers to assess premiums to businesses. The board has approved the use of 5 rating tiers, with tier 1 assessed the

lowest premiums and tier 5 assessed the highest. Each tier has a different loss cost multiplier and a different adopted loss cost assessment. The average of MSF loss costs are similar to the loss costs assessed in tier 3. For businesses assessed premiums under tier 3, MSF loss costs will be 13.8% lower than NCCI loss costs in FY 2012. By comparison MSF tier 3 loss costs for FY 2011 were 21.9% lower than NCCI loss costs.

### **Decreased Contribution to Equity**

Changes to the costs of providing benefits can change over the life of the claim due to:

- Higher loss costs than anticipated
- Changes to benefits as the result of court cases
- Changes included in statute

Equity is used to fund these unanticipated costs. As a result, a component of premiums is calculated for contribution to equity. As approved by the board for FY 2012, the target contribution to equity is 5.5% or an estimated \$7.3 million. This is a reduction from FY 2011 contribution to equity of 7.5%. As projected for FY 2011 contribution to equity included in net premiums would be \$12.2 million.

### **Static Operational Costs**

Another change to the LCM components relates to operating costs. While the cost of providing medical and indemnity benefits to injured employers included in the loss costs are decreasing, the operational costs of MSF are static or fluctuate at different amounts from the loss costs. In total, operational costs in FY 2012 are slightly lower in FY 2012 than in FY 2011. These are discussed further in the report under Statutory Operational Expense Ratio.

In addition, one of the effects of the significant reduction in net premium income in FY 2012 is that the costs of operating MSF are recovered from a smaller base. As less revenues are budgeted in FY 2012, the percentage included for operational costs is increased to provide for a similar amount of funding as that expended for operational costs in FY 2011.

### **Less Investment Income on Reserves Over Time**

As approved by the board for FY 2012, the components of the loss cost multiplier include an assumed investment yield of 3.25%. Due to benefit changes included in HB 334, NCCI and MSF both anticipate that the length of time claims are paid to injured workers will be shortened. Loss reserves are the portion of premium revenues collected for the payment of benefits over the life of the claims occurring in FY 2012. This funding earns investment income and a component for investment income is included in the loss cost multiplier. This change results in less investment generated on loss reserves.

### **Minimum Premiums Decrease 3.75%**

For 3,900 employers with little or no payroll, MSF charges a minimum annual premium. The minimum is comprised of two components:

- Minimum loss-based premium
- Expense constant

For FY 2012, based on loss experience the board approved an overall reduction in the minimum premium of \$15, from \$400 to \$385. This represents an overall reduction of 3.75% in premium costs for the smallest employers. The board reduced the minimum loss-based premium by \$20, from \$245 to \$225, and increased the expense constant \$5, from \$155 to \$160.

### **State Agency Loss Costs Decline**

NCCI loss costs are not used for state agencies. Figure 1 shows the board adopted FY 2012 loss costs for state agencies compared to the FY 2011 loss costs.

Figure 1

Montana State Fund State Agency Loss-Cost Modifications Approved May 20,2011				
Class Code	Class Description	FY 2011 Loss - cost	FY 2012 Loss - cost	Loss - cost Change
7424	State Aircraft Operation NOC: Flying Crew	5.34	3.99	-25.3%
7721	State Penal Institution: All Other Employees	5.40	4.14	-23.3%
7722	State Highway Patrol Officers	4.45	3.76	-15.5%
8743	Municipal: Professional or Administrative	1.08	0.78	-27.8%
8744	State Hospital, Penal: Prof or Administrative	1.15	0.83	-27.8%
8811	State: Clerical Office Employees	1.75	1.31	-25.1%
8834	State Hospital: All Other Employees & Drivers	12.30	8.24	-33.0%
9411	State Highway Dept: Admin or Non-Professional	2.12	1.46	-31.1%
9412	State: Administrative or Non-Professional	2.06	1.39	-32.5%
9421	State Highway Dept: All Others & Drivers	10.84	8.60	-20.7%
9422	State: All Other Employees Noc & Driver	9.40	7.22	-23.2%
9424	Municipal: Relief Workers	6.43	4.73	-26.4%
9427	Community Service Workers	6.43	4.73	-26.4%

Changes are based on the loss experience of the various state agencies for each of the class codes. The final amount of premium costs incurred by state agencies will be modified by their related experience rating, loss cost multiplier, and other factors. According to MSF, the reductions for state agencies will average about 20% and are due primarily to the changes included in HB 334.

In addition, MSF notes that state agency losses tentatively show changes that could result in additional decreases in costs as the result of work conducted by the Health Care and Benefits Division implementing stay at work/return to work programs and safety programs for state employees. Both program are included as part of the changes outlined in HB 334 and are shown in that section of the report as changes that could not be explicitly estimated by NCCI at this time.

The legislature reduced general fund appropriations for workers' compensation costs in some agencies in anticipation of the effects of HB 334 and further required that state agencies return savings generated from reduced workers' compensation costs to the fund paying the costs.

### Achievement of Reserve to Equity Targets

If estimates of the costs of FY 2012 future benefits change from the currently estimated cost of \$114.7 million needed to be set aside in loss reserves, the amount of the loss reserves must be adjusted. If the costs increase, this is known as prior year development. Funding for the additional reserves comes from investment income or equity. In FY 2011 development on prior accident years was estimated to be \$9.0 million. 3<sup>rd</sup> quarter estimates by MSF project it will need to set aside an additional \$6.74 million in loss reserves or \$2.3 million less than anticipated. In FY 2012 development on prior accident years is estimated to be \$5.3 million.

The adequacy of the equity used to offset increases to loss reserves is measured using reserve to equity ratios, as this ratio reflects the multi-year nature of MSF's obligations.

Figure 2

Montana State Fund Suplus to Equity Targets				
	Projected	Revised	Revised	Actual
	FY 2011		FY 2012	
FY 2010	4.24			3.47
FY 2011	3.88	3.05		2.86
FY 2012	3.55	2.77	2.70	
FY 2013	2.48		2.46	
FY 2014	2.27			

The multi-year nature of obligations refers to the need for MSF to use current net premiums to pay benefits for workers injured in FY 2012 over next 60 years or so. The lower the reserve to equity ratio (2.0 to 1.0 compared to 4.0 to 1.0) the greater the financial strength of the insurer and in MSF's case, the lower the risk that the state's general fund will be needed for unfunded liabilities. Due to the significance of the long term risk associated with the need for additional loss reserves in the New Fund, the budget analysis has focused on reserve to equity ratios of MSF for the last several years. Figure 2 presents equity to target ratios contained in MSF board approved strategic business plans for FY 2010, FY 2011, and FY 2012.

As shown, in FY 2010 the board set the reserve to equity ratio target at 4.24 to 1.00. The actual reserve to equity ratio achieved in FY 2010 was 3.47 to 1.0, a significant improvement. The FY 2011 reserve to equity ratio target set by the board in FY 2010 was 3.88 to 1.00. This was revised downward in the FY 2011 strategic business plan to 3.05 to 1.00. The current estimate of the actual reserve to equity ratio for FY 2011 is 2.86 to 1.00. If the targets are achieved as proposed through FY 2013 MSF should achieve the reserve to equity targets of 2.0 to 2.5 to 1.0 recommended by MSF's contracted actuary, reducing the long term risk to the legislature that prior year development may result in an unfunded liability for the New Fund.

## STATUTORY OPERATIONAL EXPENSE RATIO

Figure 3 shows the statutory operational expense ratios from FY

2000 forward. This ratio shows the ratio of operational costs to the net premiums. Benefit costs, equipment, and capital leases are excluded from the calculation. Depreciation expense on the building and amortization expense on software are added.

As shown, the operational expense ratio declined from a high of 33.4% in FY 2000 to a low of 20.3% in FY 2009. Since FY 2009 the statutory operational expense ratio has increased. In FY 2011 the ratio is projected to be 32.8% as compared to the budgeted ratio of 27.8%.

Reinsurance programs are insurance programs for insurance companies. MSF has two parts to its reinsurance programs:

- Excessive Loss Program – provides for catastrophic coverage above \$5.0 million
- Aggregate Stop Loss Program – provides funding to stop aggregate losses above a certain point

Figure 4 provides information on the budgeted and actual components of MSF reinsurance program for FY 2011 and budgeted for FY 2012. If the aggregate stop loss program is not used to offset increased costs for losses it reduces overall expenses of MSF. The funding not required for aggregated loss costs is recorded as contingent commission and offsets operational expenses within MSF. In FY 2011 aggregated losses were 78.06%. This was above the attachment point for the reinsurance program of 72.7%. The reinsurance program provided \$9.8 million to offset higher aggregated losses in FY 2011, thus reducing the amount available for contingent commissions that offset expenses of MSF.

Figure 3

Montana State Fund New Fund Changes to Operational Expense Ratio	
Fiscal Year	Operational Expense Ratio
2012	32.34%
2011	32.78%
2010	25.08%
2009	20.30%
2008	19.78%
2007	25.06%
2006	21.03%
2005	22.09%
2004	25.62%
2003	28.56%
2002	30.02%
2001	32.90%
2000	33.40%

Figure 4

Montana State Fund Reinsurance Program Budgeted compared to Actual ( in millions)			
Area of Impact	Budgeted FY 2011	Actual FY 2011	Budgeted FY 2012
Premiums Ceded - cost of reinsurance*	\$13.3	\$11.3	\$8.8
Expense - contingent commissions	\$13.5	\$2.9	\$8.4
Losses - reinsurance recoverable	\$0.0	\$9.8	\$0.0

\* Renegotiated contract in FY 2011 to reduce cost

This resulted in the higher than anticipated statutory operational expense ratio because the expenses increased.

The FY 2012 budget proposal for the statutory operational expense ratio is 32.3%. As discussed previously, net premiums decrease in FY 2012, from \$167.8 million projected for FY 2011 to \$132.8 million budgeted in FY 2012. In addition, operational costs remain static overall when compared to FY 2011. The static operational costs as a ratio of decreased premiums result in an expense ratio of 32.34% budgeted in FY 2012.

Overall operational expenditures decrease 1.3% or about \$628,000 when compared to FY 2011 projected operational expenditures. Two components of the budget drive the operational costs:

- Personal services costs which are historically 50% of the budgeted operational costs
- Commissions to insurance agents

As budgeted in FY 2012, personal services increase 3.8% when compared to FY 2011 projected expenditures and 4.6% when compared to FY 2011 budgeted amounts. This does not include the impacts of the employee incentive program discussed below.

Commissions to insurance agents are directly and proportionately related to gross premiums and as such decrease when net premium revenues decrease. The average base commission is budgeted at 7.7% of gross premiums written by the agent. In addition, MSF provides agents writing \$100,000 or more in premiums incentive payments if the loss experience of the businesses is less than anticipated. MSF anticipates the average agency incentive commission rate to be an additional 1.5%.

In FY 2012 commissions are budgeted at \$8,813,885, a decrease of \$1,263,986 or 12.5% compared to the FY 2011 costs. Commissions in FY 2012 represent 47.5% of operating expenses and 18.9% of total operational costs.

### **Nonbudgeted Personal Service Costs**

Merit adjustments for executive staff were not budgeted in FY 2011 and CEO merit adjustments are not included in FY 2012. Employee incentives are not included in the budget for either year. Employee incentives are only paid if MSF achieves various established performance targets and paid not at all if net operating income is not achieved above a certain level. As such, achievement of performance targets is not guaranteed and not included as part of the anticipated salary costs budgeted by the board. These are discussed further below.

### ***Merit Adjustments***

In FY 2012 employee merit adjustments are budgeted within personal services at 2.8 %. The budget does not include merit adjustments for the CEO as this is a separate decision by the board made at its September board meeting. In FY 2011 merit increases for executive staff were not included as part of the personal services



budget. Management staff received a total of \$42,245 in merit increases in FY 2011, an average of 3.89% per executive employee. In FY 2010 the CEO and executive staff decided to waive merit increases to executive staff.

### ***Employee Incentive Program***

The amount of employee incentives is determined through a weighted formula depending on MSF achievement of incentive targets. For FY 2011 MSF accrued employee incentive payments of \$1,315,492 estimated to be due to employees based on FY 2011 results. The board considered the performance results for FY 2011 and approved 18.7370% of the base salary as incentive for the CEO. Employee incentives use similar measurements to determine the percentage of base salary available to employees, including the executive team. Both the CEO and executive team submitted letters to the board waiving their incentive payments in light of the difficult economic conditions in Montana at this time and concerns that compensation issues may detract from the overall performance of MSF. As approved, the incentives will be paid in FY 2012 but are not included in the FY 2012 budget for personal services.

FY 2012 employee incentives will be paid in FY 2013 if targets are reached. The board increased the percentages of payout opportunities for the various targets for the CEO for FY 2012. Payout opportunities for the CEO range from 12.5% for attaining the threshold targets to 37.5% if MSF attains all targets at the outstanding level. If MSF attains all targets at the threshold level the CEO has the possibility of receiving an additional \$31,460 in additional compensation. The probability of achieving threshold targets is estimated to be 80%. If MSF were to attain all targets at the outstanding level (a 20% probability) the CEO has the possibility of receiving an additional \$94,380 in additional compensation.

### **\$21.5 MILLION IN GENERAL FUND NEEDED FOR OLD FUND IN THE 2013 BIENNIUM**

The state's general fund is responsible for the payment of claims and related administrative costs of the funds at the time they are due once the current resources of the funds are exhausted. As a result, the state's general fund is responsible for Old Fund claims costs in 2013 biennium. MSF contracts with an actuary to determine the costs of the claims and related administrative costs. The actuary has several estimates, low, high and central. The central estimate is recommended by the actuary for use in determining the costs of the claims. The MSF actuarial central estimate for the general fund costs of benefits in the 2013 biennium is \$21.5 million.